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UKRAINIAN BUDGET FOR YEAR 2000

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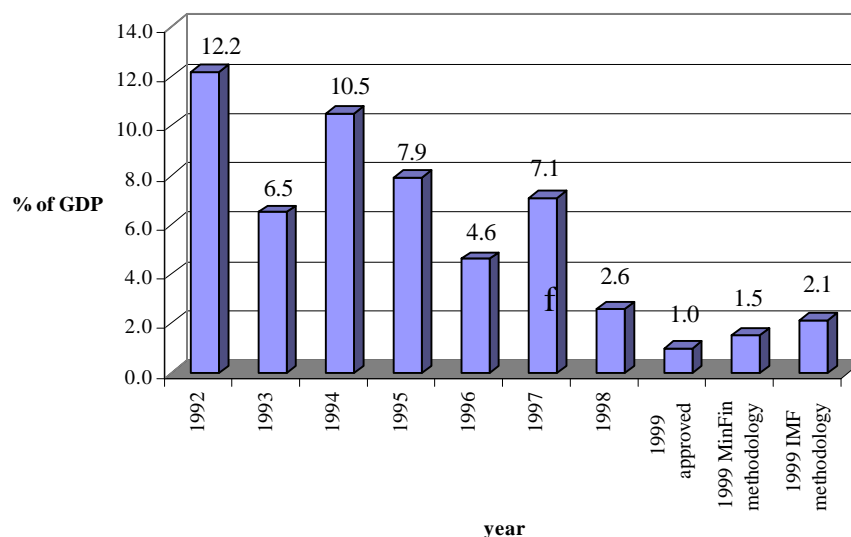
1. DEVELOPMENTS IN YEAR 1999

Taking into account the developments on economic and political scene in Ukraine the execution of the 1999 Budget was carried out in overall unfavorable conditions prevailing in the country. First, original government's draft was rejected by the Parliament, which took over the initiative of budget planning. Finally, Verkhovna Rada passed the budget in the form relatively close to the government's proposal. In general, budget presented some positive developments in the fiscal policy, however there were several important problems that it did not address to sufficient extent. Second, according to the majority of experts it was based on the unrealistic macroeconomic assumptions. To a large extent it affected the possibility of meeting the budget commitments. The weaknesses of budget planning manifested themselves in the necessity to gradually cut expenditures and attempts to find additional sources of revenues during the year. At the same time new laws were adopted, which allowed for writing off and restructuring debts as well as granting new tax privileges. Such practices in the budget implementation reduce its transparency and definitely do not help to build credibility. Third, budget execution was subject to substantial pressure from the side of political interest groups during the pre-election period of the year. All these negatively influenced the budget execution. The efforts to bring the budget deficit down can at least be viewed as the sign of understanding balanced budget necessity but still insufficient measures in this direction.

1.1. BUDGET DEFICIT

According to the Ministry of Economy methodology Ukraine's consolidated budget deficit amounted to UAH 1 926 million in 1999, i.e. 1.5 % of GDP compared with 2.6 % in 1998 and 7.1 % in 1997. At the same time it was 0.5 % higher than the approved budget deficit limit (at the level of 0.96 % of GDP). Official figures seems to be underestimated since budget deficit calculated according to the IMF methodology was equal to 2.14 % of GDP (excluding privatization receipts from the budget revenues).

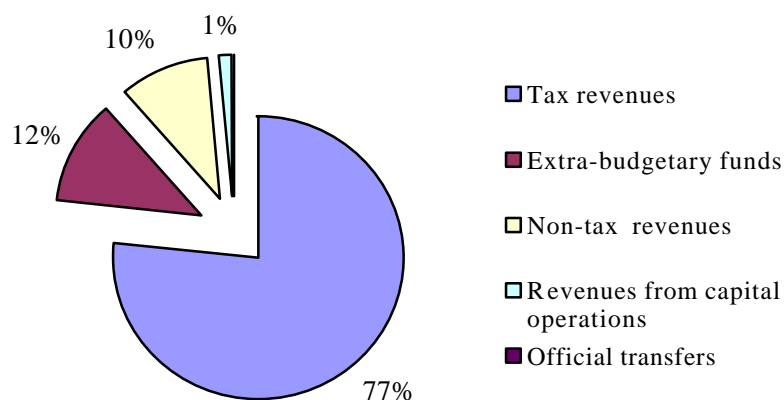
FIGURE 1. BUDGET DEFICIT 1992-1999, % OF GDP



1.2. BUDGET REVENUES

As in the previous years, the government's unrealistic projections of revenues and the lack of fiscal discipline led to actual performance short of the original budget estimates. Consolidated budget revenues amounted to 94.4 % of the annual planned figure. Total budget revenues constituted 25.4 % of GDP. Tax revenues reached 19.5 % of GDP and showed 97.9 % collection mostly contributing to execution of the approved total revenues of the budget. The failure to meet the target was due to insufficient generation of non-tax revenues, which demonstrated very poor performance of only 57.9 % of the projected sum.

FIGURE 2. COMPOSITION OF TOTAL CONSOLIDATED BUDGET REVENUES, 1999



1.3. BUDGET EXPENDITURES

Consolidated budget expenditures amounted to 96.5 % of the planned budget. Total budget expenditures were estimated at 26.9 % of GDP. The government was overspending on many items comparing to what was allocated in the budget. Considerable overspending took place in the case of housing and communal services¹, operations of the executive branch of government, and transportation, road maintenance and communications (400 %, 168 %, and 164 % of planned execution respectively, mainly on the level of local budgets). On the other hand to restrain national expenditures the government limited spending on some other items. The highest reductions took place in international operations, scientific and technical development, some services connected with economic operations, environmental and nuclear safety (46 %, 57 %, 57.8 %, and 68.9 % of planned spending respectively). Such measures led to the actual expenditures slightly lower than approved in the budget.

In sum, it appears that budget execution faced important deficiencies. First, although the government managed to curb the expenditures slightly below their planned level revenue collection proved shortcomings. Second, the budget deficit was higher than previously estimated.

2. BUDGET FOR YEAR 2000 – GENERAL OVERVIEW

On February 17, 2000 the Parliament adopted at its third reading a deficit-free national budget for the year 2000. The “Law on the State Budget of Ukraine for 2000” entered into force on March 14. It provides for revenues and expenditures each totaling UAH 33 433 million. Budget 2000 represents further development in the efforts to reduce the size of budget deficit. For the first time in the history Ukrainian authorities try to implement balanced budget (according to the Ukrainian methodology). However, taking into account the past experience of difficulties with budget execution, the doubts may arise whether those commitments will be met. Immediately after budget approval the IMF experts expressed believes that the revenues are overstated by approximately UAH 1 billion. Moreover, such budget formulation can be considered as unavoidable necessity due to substantial problems with mobilizing both domestic and foreign financing sources.

One month after budget approval the Parliament adopted changes aimed at boosting state budget revenues. Approved changes increase both the revenue and expenditure side by UAH 880 million. The revenue part of the budget was increased by canceling part of the privileges on profit and income taxes and by canceling VAT refunds during barter operations in foreign economic activity. It appears that additional revenues achieved through the mentioned tax system changes could limit the threat of repeated overestimation and reduce the risk of eventual budget deficit at the end of the year 2000. Unfortunately, additional sources are to facilitate an increase in budget allocations, among others, to: local budgets, finance the State Customs Service, law enforcement organs, Parliament. At the same time the law grants the Cabinet the right

¹ Due to the delay in adjusting prices of housing and municipal services.

to sequester budget expenditures if incomes to the budget vary more than 10 % with the established ones. However, it must give the priority to expenditure on social protection. The possibility of sequestration undermines the transparency and credibility of budget process. Sequestration, which takes place at the budget execution stage, hampers the state priorities meeting. It results in considerable difficulties in the long-term planing. Usually, the cuts are exercised in purchases of goods and services, which are to be done during sequestering time and not in the least needy services and commodities. Sequestering leads to accumulation of arrears since the obligations cannot be assumed according to planned appropriations.

2.1. MACROECONOMIC ASSUMPTIONS AND SOME PROVISIONS

The budget for year 2000 is based on the following assumptions regarding the main macroeconomic indicators:

1. nominal GDP will amount to UAH 150 800 million
2. real GDP will grow by 1 per cent
3. CPI will increase by 19 % on average and 15.9 % from December to December
4. Average exchange rate will be 5.7800 UAH/USD

The government has reviewed its macroeconomic forecasts during budget planning for several times. Among other things, the forecast of average annual exchange rate was changed from 5.0000 to 5.7800 UAH/USD while the average annual inflation was raised from 17.6 % to 19 %. The forecast annual GDP growth was set at 1 % comparing to the previous propositions of 2 % and than 0.5 %. According to the Ministry of Economics the main macroeconomic indicators have been reviewed because of the encouraging 5 % growth in industrial production reported in January 2000.

Among others, the budget law introduces the following abolition:

- some of the legislative acts that provided for granting privileges and paying compensations from the central and local budgets
- provision of loans from the state budget
- privileges involving free installation of telephones and free telephone services, free use of public transportation facilities.

Moreover, the law prohibits:

- restructuring or cancellation of debts on taxes or collections to the budget incurred by enterprises as of January 1
- settlement of salary and pension debts in non- cash form.

2.2. EVALUATION OF EXECUTION RISKS

The following Table 1 illustrates the main items of budget revenues and expenditures, their approved values and share in the GDP.

TABLE 1. BUDGET 2000

	Approved value in UAH million	Approved value in % of GDP
TOTAL REVENUES	33433	22.3
		0.0
Tax Revenues	19840.7	13.2
Non-tax Revenues	8967.3	6.0
Receipts from capital transactions	23	0.0
Official transfers	1306.5	0.9
State directed funds	3295.5	2.2
TOTAL EXPENDITURES	33433	22.3
State administration	2004.6	1.3
Judiciary authorities	195.2	0.1
International affairs	722.2	0.5
Research and development	534.1	0.4
National defense	2405.6	1.6
Law enforcement	1905.7	1.3
Education	2313.5	1.5
Health care	718	0.5
Social protection	3727	2.5
Municipal economy	2.2	0.0
Culture	147.7	0.1
Mass media	157	0.1
Sports	111.4	0.1
Industry and enery	1867	1.2
Construction	419	0.3
Agriculture	412.6	0.3
Transportation	805.5	0.5
Services related to economic activity	465.8	0.3
Liquidation of the consequences of the Chernobyl disaster	1812.9	1.2
Environmental protection	113.5	0.1
Prevention of natural calamities	121.1	0.1
Replenishment of state reserves	28.6	0.0
National debt servicing	5957.6	4.0
State directed funds	1955	1.3
Other	587	0.4
Local budget subsidies	3943.2	2.6

According to the law balanced budget revenues and expenditures amount to UAH 33 433 million. The budget is to be shared between the state budget and extra-budgetary fund in the following proportion: UAH 28 747 million and UAH 4 686 million respectively.

An analysis of the above data reveals that incomes from taxes are mostly contributing to the budget revenues. However, they are forecasted to amount 13 % of GDP only. Comparing to the East European countries, where on average tax revenues are estimated at about 40 % of GDP, this value seems to represent very low level. Especially it may not be sufficient enough taking into account the fact that Ukraine needs to finance complex economic reforms. It seems that such low level of budget revenues is not justified by necessities. Budget revenues could be much higher if incomes of shadow economy were incorporated into official one.

Moreover, the government forecast significant reduction in the size of budget expenditures. They are estimated at 22 % of GDP, which means the reduction by about 5 % of GDP in relation to the years 1996-1999. It may reflect a move towards the restructuring the government spending providing that public finance and administration reforms are successfully implemented. On the other hand, the decline of government consumption may equally be the result of lack of sources for funding budget expenditures and necessity to meet obligations of significant payments on state debt.

Although the government managed to formulate deficit free budget, the budget would not seem to be balanced if the State Privatization Fund was not instructed to direct no less than UAH 2 572 million to the budget from privatization of state enterprises. According to the IMF methodology, i.e. excluding privatization receipts from the budget revenues item, budget deficit would approximately amount to 1.7 % of GDP. If we take into account the deficit in the extra-budgetary funds and tax arrears to the budget the budget deficit would be even greater. It appears that following year the government is trying to apply the well known, from previous years, method of budget formulation, which allows underreporting official budget deficit.

To evaluate the possibility of successful budget execution we base our analyses on the forecast prepared by CASE modeling group. Following assumptions have been made about the main macroeconomic indicators:

1. real GDP growth will account for 1.6 %
2. by the end of the year monetary base will increase by 22 %
3. CPI will increase by 25 % on average and 20.9 % from December to December

Reliable nominal GDP forecast is one of the essential factors in the case of future budget indicators' realistic projection and evaluation. According to the CASE estimates nominal GDP in 2000 will reach UAH 153 400 million. Above assumption differs from macroeconomic assumptions applied by the government in the process of budget formulation. Thus, the discrepancies may be expected to influence the possibility of balanced budget execution.

It appears that in this year nominal GDP seems to be more realistically forecasted what gives the chance for nominal budget revenues not to be exaggerated. For instance, in 1997 general level of actual and planned revenues in relation to GDP was practically the same. But in nominal terms it turned to be 92.4 % of the planned indicator as actual nominal GDP reached only 93 % of the forecast.² However, there

² *Open Budget 1999 for Ukraine*, Institute of Reform, International Center for Policy Studies, Ukrainian-European Policy and Legal Advice Center, Kyiv, May 1999

still remains the question how realistic revenue estimates and collection abilities are assumed. Regrettably, year after year, Ukrainian authorities appeared unable to apply credible budget planning. In addition, the process is regularly interfered with inefficient taxation policy. Ukraine has not been able to overcome these problems and as a consequence revenue collection is weak and actual revenues are consistently lower than plan. A number of factors in tax system impact negatively on the persistent budget revenue shortfalls:

- high taxation rates
- excessively generous system of tax privileges and exemptions
- inefficient tax administration
- growth in tax avoidance and arrears.

The authorities have obviously failed to incorporate the experience from the previous years' budget execution into the evaluation of the expected budget indicators. As there recently have not been any substantial changes to tax system and complex tax reform still remains in the sphere of declarations we expect that the government will be forced to face the same dilemma.

The following Table 2 summarizes consolidated budget revenues execution in relation to their planned values over the recent years.

TABLE 2. BUDGET REVENUE EXECUTION 1996 – 1999

(plan values in UAH million, execution in % of plan)

	1996		1997		1998		1999	
	plan	exec	plan	exec	plan	exec	plan	exec
TOTAL REVENUES	35900	84.2	31337.7	89.7	32015.5	88.8	34252	94.4
Tax Revenues	17808.8	95.5	19625.5	108.5	19300.3	111.3	25345.4	97.9
Non-tax Revenues	5571.1	4.5	5971.3	1.3	3697.4	2.4	5594.5	57.9
State directed funds	8976.6	9.6	3198.6	2.6	5601.7	4.2	2899.5	133

As shown in the Table 2 actual budget revenues have been consistently below the planned over recent years. In 1996 consolidated budget receipts were only 84.2 % of planned value. The execution has slightly improved over the last 3 years but still is unsatisfactory. Revenues of the consolidated budget were 89.7 % and 88.8 % of the planned revenues in 1997 and 1998 respectively. The same is characteristic for the execution of the budget 1999 when they reached only 94.4 %. The most considerable discrepancies are those in the planning of non-tax revenues. A tendency to substantially overestimate non-tax revenues persisted during preparation of the budgets for each following year.

According to CASE analyses³ it should be noted that the government while planning budget revenues from the majority of tax categories, for the first time since many years, based its estimates on actual revenue collection in 1999. It appears that 1999

³ *Memorandum. Macroeconomic Forecast.*, monthly bulletin No. 28, CASE

performance was used as a base for revenues from income taxes, VAT, and excise duty. Unfortunately, revenues to be collected from a number of non-tax items are again biased by overestimation, as mistakes made in the previous years have not been taken into account. It mostly refers to revenues claimed from natural gas transit and rent for oil and gas mined in Ukraine. Moreover, mentioned revenues should be allocated for servicing foreign debts of the country this year. Therefore, about one third of funds reserved by the government in the budget for servicing foreign debts probably to a large extent will not be collected.

In addition, we find one more issue, which will prove the budget estimates and deficit free assumption rather unrealistic. The government expects to collect UAH 2.5 billion from privatization receipts this year (about misleading classification of receipts from privatization of state assets we have already commented). First of all, the Parliament has not approved the privatization program yet. Second, it is highly probable that even in the case of successful privatization process majority of funds will be collected not earlier than in the fourth quarter of 2000 or, what is more likely, next year.

The overestimation of macroeconomic and fiscal indicators at the budget formulation stage has led to a consistent tendency to overestimate potential for expenditures for many years. Consolidated budget expenditures have been constantly unfounded and not executed as provided by law over all recent years. As Table shows funded expenditures range between 84 % to 96.5 % of approved appropriations during 1995-1999.

TABLE 3. BUDGET EXPENDITURE EXECUTION 1996 – 1999
(in % of approved value)

	1996	1997	1998	1999
ACTUAL EXPENDITURE AS % OF APPROVED	92.6	93.5	90.8	96.5

The underfunding of voted budget appropriations is a direct consequence of unreliable budget forecast and difficulties with revenue collections. As a result accumulation of budget sector arrears takes place. The problem of compliance with adopted budget is also influenced by the practice of funding public expenditures in the form of mutual settlements. Although in the most of budget operation mutual clearing has been legislatively prohibited it is still the method of carrying out financing. Also the law “On State Budget of Ukraine for 2000” allows mutual settlements in some operations involving compensation of citizens’ lost deposits and those involving the Ministry of Defense. Although the government authorities categorically oppose to mutual settlements with exception of those above mentioned, the IMF experts strongly criticized the conduction of such practices involving budget operations.

3. CONCLUSIONS

Listing the government's achievements in the field of budget formulation one can summarize the evaluation of budget execution possibilities:

- For the first time in Ukraine's history the government managed to formulate deficit free budget (according to the Ukrainian methodology).
- The majority of tax revenue categories is estimated basing on an actual revenue collection in 1999.
- The budget is based on more realistic reviewed macroeconomic indicators comparing to the previous years.
- The nominal GDP can turn to be higher than forecasted what would contribute to higher budget revenues. It can result in at least fulfillment of approved revenues when we take into account traditional overestimation of revenues on the planning stage.

However, there are several factors, which may trigger the execution of balanced budget in 2000:

- Once again the privatization receipts has been classified as budget revenues what results in considerable budget deficit underestimation according to international standards.
- Privatization program has not been approved yet.
- Privatization receipts are probably overestimated and doubtful in this year.
- Revenues from some non-tax categories are by far overestimated. They will be lower than expected, which can be considered as implicit budget deficit.
- Negative impact of inefficient tax system on abilities to mobilize budget revenues in amounts forecasted in the budget.

To conclude, the above mentioned deficiencies may cause the government to face the problem of actual budget deficit in the following months. In such a situation the government may be forced to apply either expenditures' sequestration or implement considerable charges into taxation system to finance budget deficit.

Some information about the budget implementation is provided in the report on budget execution during the period of January – February 2000. The consolidated budget for the first two months of the year was met with a UAH 738 million surplus. In particular, the consolidated budget revenues for analyzed period amounted to 9.8 % of the planned value for the entire year. At the same time the execution of expenditures was estimated at 7.6 % of approved spending. However, this surplus appears to be a result of insufficient financing of expenditure rather than an increase in revenue collection over the planned level. If we analyze these developments in comparison to amounts foreseen for the first quarter of the year it turns out that achieved revenues constitute 64.2 % of plan but actual spending is only 40.6 % of appropriations. Moreover, only in January the tax arrears to the consolidated budget rose by 9.6 % to reach UAH 13 billion. According to the State Tax Administration one of the major tax debtors in January was the Naftogaz Ukrainy company, which failed to pay UAH 400 million in taxes.